Staking Claims in PE

Analysis of stakes in general partner management companies

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Key takeaways

- General partner (GP) stake deals are quickly gaining attention as a new investment strategy, with major players such as Goldman Sachs, Dyal Capital Partners, and Blackstone, among others, all raising funds to acquire minority equity positions in the management companies of alternative asset firms. A total of 11 funds explicitly focused on GP stakes have now been raised.

- PitchBook currently has data on 64 GP stake deals, including 27 deals completed since the beginning of 2016. Hedge funds were once the primary target of such investments, but private equity firms are now accounting for more than half of all GP stake deals; this trend is likely to continue as more capital is dedicated to strategies that explicitly target PE firms, many of which are using GP stake investments to facilitate succession plans.

- Since GP stake deals introduce a new participant into the traditional LP-GP relationship, these deals can alter the value proposition and alignment of incentives because GPs now must consider the interests of the minority investor as well as the LPs in their funds.

Introduction

As PE (and the alternative investment industry in general) has continued to evolve and mature, investors have sought new ways to access the asset class. Limited partners (LPs) are increasingly seeking ways to forge tighter relationships with GPs and to gain additional exposure to underlying deals. In recent years, this trend has manifested itself through more customized mandates and a proliferation of co-investments. Now, LPs are taking the next step by formulating investments in the management companies of the GPs themselves.

Prime cut? Defining GP stakes

GP stake deals (also known as a minority stake deals) are similar in structure to seeding a new manager, but there are two major differences.

One key distinction is that seed deals are typically structured as an LP commitment to a fund, whereas a GP stake deal is a direct equity investment in the GP's underlying management company. Seeding is typically associated with alternative managers operating strategies of greater liquidity, such as hedge funds, that are raising an initial fund and would benefit from a long-term capital commitment. In exchange for the relatively longer lockup of capital, seed investors receive preferential terms on their commitment and get to participate in revenue share with the GP. First-time PE funds often strike similar arrangement with so-called anchor investors, which provide a substantial early commitment to a fund in exchange for special terms, such as reduced fees and a right of first refusal on co-investments.

Investors in GP stake deals enjoy many of the same benefits associated with seeding; however, GP stake investments represent a purchase of a minority (typically non-voting) ownership position in the GP's underling management company, as opposed to a seeding, which is essentially an LP commitment that includes special privileges. Due to their structural differences, seeding and GP stake deals tend to target managers at different stages of their development. Whereas seed deals generally involve new and emerging managers, the targets in GP stake deals are typically well-established firms with a track record of strong performance.

GPs sell minority positions to generate an influx of cash that can subsequently be used for a variety of purposes, including to execute acquisitions, to provide liquidity to founders and partners, and to fuel the development of new strategies and funds. When raising new funds, GPs need to commit their own capital alongside LPs to ensure they have "skin in the game" and to help align incentives; however, it can be difficult for junior professionals to fulfill this commitment, particularly for larger funds. Some GPs are using the capital raised through GP stake sales to help junior investment professionals bridge this gap. In return for their GP stake investment, LPs receive greater access to the best-performing managers as well as a portion of future management fees—not to mention the potential for appreciation in their equity stake.

Select firm profiles

DYAL | CAPITAL PARTNERS

Location: New York, NY
Year Founded: 2012
Fully Invested: Dyal Capital Partners I
Active Funds: Dyal Capital Partners II & III

Number of Investments: 24

Dyal Capital Partners is a PE firm that is dedicated to acquiring minority equity stakes in established alternative asset managers' companies diversified by investment strategy and geography. The firm was founded in 2010 and operates as a subsidiary of Neuberger Berman Holdings. Tracing its roots back to predecessors founded in the early 1980s, NB Private Equity is recognized as one of the oldest PE investment firms and has managed PE separate accounts and commingled funds for institutions globally. Since its inception, NB Private Equity has been an active PE investor managing investor commitments across primaries, co-investments, private debt, other direct PE strategies and secondaries.

Select firm profiles

Goldman Sachs

Location: New York, NY
Year of First GP Stake Fund: 207
Liquidated Funds: Petershill I
Active Funds: Petershill II, Petershill Private Equity

Number of Investments: 14

Goldman Sachs Alternative Investments & Manager Selection Group is an investor in private equity funds. The firm offers fund-of-funds, co-invests in direct investments, and provides liquidity and portfolio management solutions to existing PE investors via the secondary market. The firm's comprehensive global PE program seeks to construct a diversified PE portfolio and considers each potential investment's strategy, geographic focus, competitive advantages and return profiles, including how a particular opportunity may affect the portfolio's volatility and risk.

History

A slow start

While GP stake deals have only begun to garner media attention, the strategy has existed in various forms for years. One of the first GP stake deals involved two stalwarts of the industry, with CalPERS acquiring a 10% stake in the Carlyle Group back in 2000. Activity was tepid for the first several years before large asset managers, such as Affiliated Managers Group (AMG) and Asset Management Finance (AMF), entered the space. Both began by investing in several hedge funds: AMG made their first minority investment via a deal with AQR Capital Management in 2004, which was followed by AMF's first minority investment in Rigel Capital in 2007. During this time, several prominent firms, including Apollo and Carlyle, sold stakes to sovereign wealth funds and other deep-pocketed LPs.

These early explorations, which were executed by a single investor which typically had a longstanding relationship with the GP, paved the way for institutional capital. In 2007, Goldman Sachs' Alternative Investments & Manager Selection (AIMS) group raised $1 billion for its inaugural Petershill fund to specifically target these types of deals in hedge funds. Neuberger Berman followed suit in 2011, establishing a new unit called Dyal Capital Partners that subsequently raised $1.3 billion in a debut fund to pursue the strategy. These vehicles were structured similarly to a traditional PE fund, with LPs committing capital to be locked up for a decade or more; however, this time the alternative investment firms themselves would be the portfolio companies.

As these funds started doing deals, the pivotal question for all involved was how to achieve an exit. Many of the early investments were made into hedge funds, some of which went belly up. A handful of high-profile failures led many to call the strategy into question, but, despite some setbacks, LPs continued to enjoy their share of management fees and eventually exits started to come. A turning point for the GP stake strategy seems to have come in 2016, when the GS AIMS Petershill fund struck a deal to sell its remaining holdings to AMG for $800 million. Reports at the time showed the sale providing a 22% premium to Petershill's investors, resulting in a 15% annualized return over the fund's life.

Select firm profiles

Blackstone

Location: New York, NY
Year of First GP Stake Fund Founded: 2013
Active Funds: Strategic Capital Holdings

Number of Investments: 6

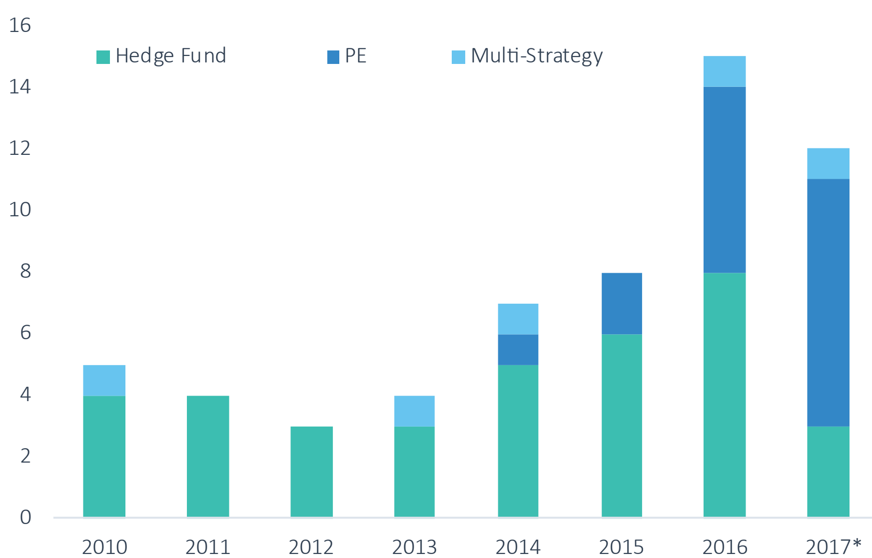
The Blackstone Group is a multinational PE firm that specializes in leveraged buyouts (including both public-to-private acquisitions and add-on transactions), restructurings, and private placement funding. The firm serves a variety of industries including energy, insurance, financial, and technology. The firm was founded in 1985 and is based out of New York, New York with additional offices in Europe, Middle East, Asia and Australia.

Same game, new players

This sale seems to have served as a catalyst for renewed optimism about the strategy: Goldman launched two more Petershill funds, Dyal Capital has now raised a total of three vehicles devoted to the strategy, and new players are coming to the forefront too. Blackstone now has a fund called Blackstone Strategic Capital Holdings, Credit Suisse is planning a fund via its newly formed Anteil Capital Partners unit, Aberdeen has hired a handful of professionals to spearhead an upcoming $1 billion fund, and Carlyle's AlpInvest has also dedicated resources to minority stakes (although Marek Herchel, who was tapped to lead the initiative, has reportedly left the firm). Other firms pursuing the strategy include Hycroft and the aptly named GP Interests.

As mentioned, some of the early GP stake funds took hits when hedge funds that they backed went under. The failures came for a variety of reasons, from poor performance and the departure of lead portfolio managers to regulatory violations including insider trading. The AUM of hedge funds can also fluctuate quickly, which can be a boon in good times but also poses a significant downside risk if redemptions occur en masse. To help mitigate this risk, many GP stake firms have been shifting their focus to less-liquid strategies—namely PE—where capital will likely be locked in for the duration of the GP stake investment.

PE's proportion has grown significantly as of late
GP stake deals by target firm type



Source: PitchBook
*As of 9/1/2017

Indeed, this shift is evident in the most recent fund from GS AIMS, which is conspicuously named Petershill Private Equity. So, while hedge funds were once the primary targets of GP stake deals, they have comprised about 40% of such deals over the last two years, with the proportion of deals into PE firms growing to more than 50%. Blackstone recently expanded its GP stake strategy into PE for the first time, acquiring a minority stake in Leonard Green & Partners earlier this year.

With the recent proliferation of GP stake funds, the strategy is quickly becoming a competitive space where funds must be ready to deliver more than just capital to GPs. Those familiar with the PE industry will quickly notice a similar theme amongst these GP stake funds: They're all overseen by some of the largest, most-diversified allocators of capital in the industry. These firms generally have longstanding fund-of-funds and/or secondaries businesses, which translates to relationships with hundreds of underlying managers. Those relationships not only serve as a conduit for deal-sourcing, they also provide the firm with deep insight into how a variety of GPs run their management company. To that end, GP stake investors are now billing themselves to PE firms in similar ways that those firms try to attract portfolio companies, touting their ability to provide insight into industry best practices, expand the GP's investor base, and leverage the capabilities of a parent firm such as Goldman Sachs or Blackstone.

This relatively new type of investment structure is likely to become more prominent as the average age of founders and partners of GPs increases and their need for liquidity becomes greater. PE firms seemed to have cooled to the idea of going public due to the lackluster performance of the household names that listed in the 2000s. And while consolidation in the industry is occurring, many partners will likely be hesitant to sell a majority interest and cede full control of the firms they've built. In this light, selling a minority stake is an attractive alternative. Of all the GP stake deals involving PE firms currently tracked in the PitchBook Platform, roughly 80% were struck in the last two years.

Where do we go from here?

As more capital flows into the strategy, we expect to see GP stake funds become more inventive in how they structure and source deals. And while funds raised by the likes of Goldman, Blackstone and others appear to have a competitive advantage, some LPs are still preferring to pursue these deals on their own. A case in point is Parkwood Corporation, a longtime LP of the Riverside company, which earlier this year acquired a 10% stake in the GP's management company.

But as the GP stake investing rapidly evolves, the future remains uncertain, with recent media attention focusing on the potential conflicts of interest associated with these deals. What is going to happen next? Will funds currently in the market hit their fundraising targets? If so, will they be able to deploy their capital efficiently? How will the exit market evolve? Is enthusiasm for the strategy a sign that there's a bubble brewing in PE?

As we continue to dive into this subject, we'd love to engage with those in the industry who might have additional insight. If you have any additional thoughts, please feel free to reach out to james.gelfer@pitchbook.com and nico.cordeiro@pitchbook.com

Pros & cons

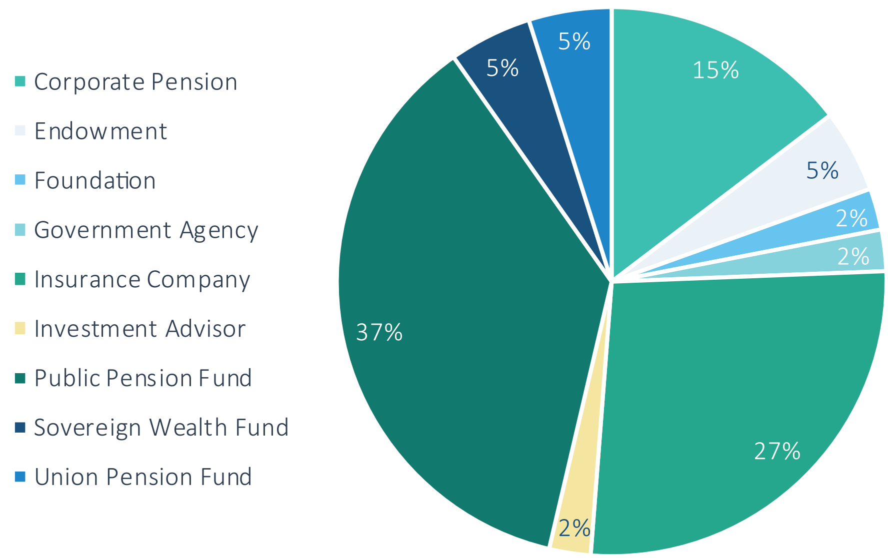
Benefits and drawbacks of GP stake deals vary for different parties, including those investing in a GP stake deal, the GP selling a minority share, and the LPs already invested in the target firm's funds. Below is a list of some of the pros and cons for the three main parties affected in a GP stake deal involving a PE firm.

	LP INVESTED IN A GP STAKE FUND	GP SELLING A MINORITY STAKE	LP INVESTED IN THE GP'S FUNDS
PROS	• Achieve a stable and recurring cashflow from the firm's management fees • Receive access, often with preferential terms, to top funds that are closed to new LP relationships • Potentially develop deeper ties with the best-performing GPs • Gain access to back-office operations and processes of the GP	• Achieve liquidity for founders and partners • Raise capital to enhance the GP management company o Raise new/larger fund(s) o Make strategic acquisitions of other PE firms o Help to fund GP fund commitments by junior investment professionals • Operational assistance o Expertise of a GP stake investor that often has allocated to hundreds of managers via fund-of-funds, secondary funds, and/or advisory relationships o Broaden network of potential LPs • Maintain a higher level of control relative to other liquidity options, such as an IPO	• Potentially retain key investment personnel who otherwise would've cashed out entirely • Increased back-office efficiency can potentially improve reporting mechanisms, creating greater transparency
CONS	• Limited options for liquidity • Like other PE vehicles, GP stake funds come with relatively high fees that can erode cashflow yields	• Potentially limits opportunities for the GPs' junior professionals to grow their stake in the management company • May feel pressure to expand investment offerings to increase management fees and the concomitant cashflows to minority stake investors	• New alignment of incentives with an outside investor in the GP management company, which could lead the GP to place greater emphasis on the needs of stake investors rather than fund LPs • Deepening relationship between GPs and minority stake investors could cause conflicts regarding new funds and co-investments • Pressure to expand and grow business could affect returns of current fund investments

LP breakdown

Given the intricacies and sensitive nature associated with GP stake investments, the firms raising these vehicles seemed to have made a concerted effort to target the most sophisticated LPs. To that end, virtually all the LPs that are committing to GP stake funds are well-established PE investors that have been allocating capital to the space for decades.

Public pension funds & insurance companies predominate
LP components of GP stake funds



Source: PitchBook
*As of 9/1/2017

- Average AUM: $55B
- Average age of LP institution: 69 years
- Average # of commitments to private capital funds: 205